

Testimony before the House Financial Services Committee

of

Carmen M. Reinhart

Professor, University of Maryland and Research Associate, National Bureau of
Economic Research

February 24, 2008

Thank you, Chairman Frank and the other members of the Committee for this opportunity to comment on the U.S. economy and the conduct of Federal Reserve policy. On a personal note, your invitation was well beyond my sense of the possible when I emigrated from Cuba to this country as a girl of ten. My family and I had three suitcases to our name and no prospects, but today I sit before this distinguished Committee and am deeply grateful.

I am currently a professor in the School of Public Policy and Department of Economics at the University of Maryland. I suspect that I was invited today because, for the past decade, my research has focused on economic crises. It is a fascinating line of work with a discouraging conclusion. Across countries and over the centuries, economic crises of all type follow a similar pattern.

An innovation emerges. Sometimes it is a new tool of science or industry, such as the diving bell, steam engine, or the radio. Sometime it is a tool of financial engineering, such as the joint-stock company, junk bonds, or collateralized debt obligations. Investors may be wary at first, but then they see that extraordinary returns appear available on these new instruments and they rush in. Financial intermediaries—banks and investment companies—stretch their balance sheets so as

not to be left out. The upward surge in asset prices continues, and that generation of financial market participants concludes that rules have been rewritten: Risk has been tamed, and leverage is always rewarded. All too often, policy makers assert that the asset-price boom is a vote of confidence on their regime. Only seldom, to my knowledge, do they protest that perhaps the world has not changed and that the old rules of valuation still apply.

But the old rules *do* apply. The asset price rise peters out, sometimes from exhaustion on its own or sometimes because of a real shock to the economy. This exposes the weaknesses of the balance sheets of those who justified high leverage by the expectation of outsized capital gains. Many financial firms admit losses, and some ultimately fail. All those financial firms hunker down, constricting credit availability in an effort to slim their balance sheets. With wealth lower and credit harder to get, economic activity typically contracts. Only after the losses are flushed out of the financial system and often with the encouragement of lagging monetary and fiscal ease does the economy recover.

This sorry spectacle repeats itself in the various types of crises, but the most relevant to you must be the aftermath of banking crises. In recent work with my co-author, Ken Rogoff of Harvard University, I documented eighteen such episodes in industrial economies over the past thirty years. Declines in assets, including those of both houses and equities that the United States has experienced over the past year, are common markers of the onset of banking crises. In the worst five banking crises

in industrial countries over the past thirty years, the value of houses fell about 25 percent on average from their peak.

The cautionary lesson for today's situation in the United States is that the decline in output after a banking crisis is both large and protracted. The average drop in (real per capita) output growth is over 2 percent, and it typically takes two years to return to trend. For the five most catastrophic cases, the drop in annual output growth from peak to trough is over 5 percent, and growth remained well below pre-crisis trend even after three years. Given this record of economic dislocation associated with banking strains, I expect that the U.S. economy is in or about to enter recession. My best hope, and I put no more 40 percent probability on the outcome, is that we are amidst a protracted slow patch. In either case, resource slack will accumulate and the unemployment rate will rise.

Of course, there are differences in each episode, just as there are similarities. The biggest difference in the United States in the period since the peak in house prices in early 2007 has been monetary policy. Thus far along, the Federal Reserve has been more aggressive in pulling down the real short-term interest rate (or the nominal short-term interest rate less a proxy for inflation expectations). And for that I hope that you congratulate Chairman Bernanke.

But I also hope that you take the opportunity to ask him three sets of questions.

First, Federal Reserve policy easing in the last five months of last year seemed to be constrained by concerns about inflation. Judging from the longer-term

projections included in the minutes of the October 2007 and January 2008 meetings, Federal Reserve policy makers seem to have an informal goal for PCE inflation (excluding food and energy) or something less than 2 percent. Was that goal reining in their response to the weakening of spending in 2007, and will it constrain their actions their actions over the remainder of this year?

Second, policy actions this year suggest that the Federal Reserve has abandoned the practice of gradually responding to economic events that marked the experience of the prior two decades. Will this phase of post-gradualism apply symmetrically later this year if evidence accumulates that inflation expectations are on the rise?

Third, Chairman Bernanke and his predecessors have previously argued that Federal Reserve involvement in the supervision of financial institutions is important in making both the conduct of supervision and monetary policy better. But the past few years apparently witnessed multiple regulatory lapses. Supervisors failed to caution depositories offering potential borrowers unsuitable mortgages. They also acquiesced as complicated structures were booked off the balance sheet, even though, in the event, they were not treated as such by corporate headquarters at the first sign of stress. At the same time, it is hard to read the hesitant easing of late 2007 as evidence that monetary policy makers were receiving useful insights from their supervisory colleagues. Does Chairman Bernanke still view supervision and regulation as an appropriate responsibility of the Federal Reserve?